Supreme Court, U.S.
FILED
MAY 3 1994
OFFICE OF THE CLERK

No. 93-823

In The
Supreme Court of the United States
October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of the State of Nebraska

BRIEF OF AMICI CURIAE ON THE MERITS IN SUPPORT OF THE STATE OF NEBRASKA, DEPARTMENT OF REVENUE BY THE STATE OF CALIFORNIA AND THE STATES OF ALABAMA, ARIZONA, DELAWARE, ILLINOIS, INDIANA, KENTUCKY, LOUISIANA, MARYLAND, MASSACHUSETTS, MICHIGAN, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OKLAHOMA, OREGON, UTAH, VERMONT, VIRGINIA AND WISCONSIN

DANIEL E. LUNGREN
Attorney General of the
State of California

TIMOTHY G. LADDISH
Assistant Attorney General
JOYCE E. HEE
Deputy Attorney General
(Counsel of Record)
2101 Webster Street
Oakland, CA 94612-3049
(510) 286-4044
Attorneys for Amici Curiae
(Continued on inside cover)

Of Counsel
PATRICK J. KUSIAK
Tax Counsel
Legal Division
Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95812-1468

JAMES H. EVANS
Attorney General of Alabama
Alabama State House
11 So. Union Street
Montgomery, AL 36130

GRANT WOODS
Attorney General of Arizona
1275 West Washington
Phoenix, AZ 85007-2926
(602) 542-5025

CHARLES M. OBERLY, III
Attorney General of Delaware
State Office Building
820 French Street
Wilmington, DE 19801
(302) 577-2500

ROLAND W. BURRIS
Attorney General of Illinois
100 West Randolph Street,
12th Floor
Chicago, IL 60601
(312) 814-2503

PAMELA CARTER
Attorney General of Indiana
219 State House
Indianapolis, IN 46204
(317) 232-6201

CHRIS GORMAN
Attorney General of Kentucky
P. O. Box 2000
Frankfort, KY 40601-2000
(502) 564-4002

RICHARD P. IEYOUB
Attorney General of
Louisiana
Louisiana Dept. of Justice
P. O. Box 94005
Baton Rouge, LA 70804-9005
(504) 342-7013

J. JOSEPH CURRAN, JR.
Attorney General of Maryland
200 St. Paul Street
Baltimore, MD 21202
(410) 576-6300

SCOTT HARSHBARGER
Attorney General of
Massachusetts
One Ashburton Place
Boston, MA 02108-1698
(617) 727-2200

FRANK J. KELLEY
Attorney General of Michigan
P. O. Box 30212
Lansing, MI 48909
(517) 373-1110

JEFFREY R. HOWARD
Attorney General of
New Hampshire
25 Capitol Street
Concord, NH 03301
(603) 271-3655

DEBORAH T. PORITZ
Attorney General of
New Jersey
Hughes Justice Complex
CN 080
Trenton, NJ 08625-0080
(609) 292-4919

TOM UDALL
Attorney General of
New Mexico
Bataan Memorial Building
P. O. Drawer 1508
Santa Fe, NM 87504-1508
(505) 827-6000

G. OLIVER KOPPELL
Attorney General of
New York
The Capitol
Albany, NY 12224
(518) 474-8101

HEIDI HEITKAMP
Attorney General of
North Dakota
State Capitol, 1st Floor
600 East Boulevard Avenue
Bismarck, ND 58505-0040
(701) 224-2210

SUSAN BRIMER LOVING
Attorney General of
Oklahoma
2300 N. Lincoln Blvd.
State Capitol Bldg., Rm. 112
Oklahoma City, OK
73105-4894
(405) 521-3921

THEODORE R.
KULONGOSKI
Attorney General of Oregon
100 Justice Building
Salem, OR 97310
(503) 378-4402

JAN GRAHAM
Attorney General of Utah
236 State Capitol
Salt Lake City, UT 84114
(801) 538-9600

JEFFREY L. AMESTOY
Attorney General of Vermont
109 State Street
Montpelier, VT 05609-1001
(802) 828-3171

JAMES S. GILMORE, III
Attorney General of Virginia
The Supreme Court Building
101 North Eighth Street
Richmond, VA 23219
(804) 786-2435

JAMES E. DOYLE
Attorney General of
Wisconsin
114 E. State Capitol
Madison, WI 53707
(608) 266-1220

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether 31 U.S.C. §3124(a) prohibits state taxation of distributions received by a shareholder of a mutual fund, when those distributions are derived from repurchase agreements involving a federal obligation.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF AUTHORITIES iv

INTEREST OF AMICI CURIAE 1

STATEMENT PURSUANT TO RULE 37 5

SUMMARY OF ARGUMENT 5

ARGUMENT 8

I SINCE THE NEBRASKA TAX TAXES NEITHER THE FEDERAL OBLIGATIONS THEMSELVES NOR THE INTEREST PAID BY THE GOVERNMENT, THERE IS NO EXEMPTION UNDER 31 U.S.C. §3124(a). 8

A. IN SUBSTANCE, THE REPURCHASE AGREEMENTS WERE LOANS; INTEREST PAID BY A PRIVATE PARTY ON A LOAN CANNOT QUALIFY FOR INCOME TAX EXEMPTION UNDER 31 U.S.C. §3124(a). . 8

B. EVEN IF THE MUTUAL FUND'S INCOME FROM A REPURCHASE AGREEMENT WERE TO BE SEEN AS INCOME FROM THE SALE OF A FEDERAL OBLIGATION RATHER THAN INTEREST ON A LOAN SECURED BY A FEDERAL OBLIGATION, INCOME FROM THE SALE OF A FEDERAL OBLIGATION IS NOT EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a). 13

C. NO MATTER WHAT TAX EXEMPT INCOME A MUTUAL FUND MIGHT DERIVE IN CONNECTION WITH FEDERAL OBLIGATIONS, THE FACT THAT SUCH INCOME PROVIDES THE SOURCE FOR A DISTRIBUTION BY THE FUND TO ITS SHAREHOLDER DOES NOT RENDER THE DISTRIBUTION EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a). . . 17

II PROHIBITING THE STATE TAXATION AT ISSUE WOULD VIOLATE THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY. . . 23

A. DISCRIMINATORY TAXATION IS PROHIBITED. 23

B. FEDERAL TAX TREATMENT OF STATE OBLIGATIONS. 26

C. SPECIAL CONSIDERATIONS APPLICABLE TO INTERGOVERNMENTAL TAXATION. . 28

CONCLUSION 30

TABLE OF AUTHORITIES

CASES: Page

Agricultural Sec. Corp. v. Commissioner, 39 B.T.A. 1103 (1939) 16

Alabama v. King & Boozer, 314 U.S. 1 (1941) 28

American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983) 12, 19

American National Bank of Austin v. United States, 421 F.2d 442 (5th Cir. 1970), *cert. denied* 400 U.S. 819 (1970) 10

American National Bank of Austin v. United States, 573 F.2d 1201 (Ct. Cl. 1978) 10

Andras v. Illinois Department of Revenue, 154 Ill. App. 3d 37, 506 N.E.2d 439, 106 Ill. Dec. 732 (Ill. App. 1987), *cert. denied*, 485 U.S. 960 (1988) 3, 4

Bewley v. Franchise Tax Board, 15 Cal.App. 4th 310 (1993), pet. for rev. granted July 22, 1993 3

Borg v. Department of Revenue, 308 Or. 34, 774 P.2d 1099 (Or. 1989) 3, 5

Brown v. Franchise Tax Board, 197 Cal. App. 3d 300, 242 Cal. Rptr. 810 (1987) 5, 18

TABLE OF AUTHORITIES

CASES: Page

Burks v. Lasker, 441 U.S. 471 (1979) 20

Burnet v. Coronado Oil, 285 U.S. 393 (1932) 24

Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue, 145 Wis. 2d 841, 429 N.W. 2d 551 (Wis. Ct. App. 1988) 3, 4

Central Hanover Bank & Trust Co. v. United States, 83 Ct. Cl. 401, 14 F.Supp. 541 (1936) 16

Citizens National Bank of Waco v. United States, 551 F.2d 832 (Ct.Cl. 1977) 10

Collector v. Day, 78 U.S. (11 Wall.) 113 (1871) 14, 24

Comptroller of the Treasury v. First United Bank & Trust Co., 320 Md. 352, 578 A.2d 192 (Md. App. 1990) 3, 5

Comptroller of the Treasury, Income Tax Division v. First United Bank & Trust Co., 320 Md. 352, 578 A.2d 192, 201 (1990) 12

Davis v. Michigan Dept. of Treasury, 489 U.S. 803 (1989) 26

TABLE OF AUTHORITIES

CASES: Page

Department of Revenue v. Page, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989) 2

Everett v. Department of Revenue and Finance, 470 N.W.2d 13 (Iowa 1991) 2

First American National Bank of Nashville v. United States, 467 F.2d 1098 (6th Cir. 1972) 10

First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 470 U.S. 583 (1985) 16, 19

Graves v. New York ex rel, 306 U.S. 466 (1939) 14, 25, 28

H.J. Heinz Co. v. Dept. of Treasury, 494 N.W. 2d 850 (Mich. App. 1992) 3

Hammond Lead Products, Inc. v. State of Indiana Tax Commissioners, 575 N.E.2d 998 (Ind. 1991) 2

Harper v. Virginia Department of Taxation, 509 U.S. ___, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993) 4

Helvering v. F. & R. Lazurus & Co., 308 U.S. 252 (1939) 9, 25

In re Thomas C. Sawyer Estate, 149 Vt. 541, 546 A.2d 784 (Vt. 1987) 3, 5

TABLE OF AUTHORITIES

CASES: Page

Indian Motorcycle Co. v. United States, 283 U.S. 570 (1931) 24

James v. Dravo Contracting Co., 302 U.S. 134 (1937) 28

Lloyd v. Commissioner, 154 F.2d 643 (3rd Cir. 1946) 16

Loewenstein v. Nebraska Dept. of Revenue, 244 Neb. 82, 504 N.W.2d 800 (1993) 13

Lombard-Wall Inc. v. Columbus Bank & Trust Co., No. 82 B 11556 (Bankr.S.D.N.Y. Sept. 16, 1982). 11

Massman Construction Company v. Director of Revenue, 765 S.W.2d 592 (Mo. 1989) 3

Matz v. Department of Treasury, 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986) 3, 4

McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819) 23

McKesson Corp. v. Division of Alcoholic Beverages & Tobacco, Dept. of Business Regulation of Florida, et al., 496 U.S. 18, 32 n. 16 (1990) 4

TABLE OF AUTHORITIES

CASES: Page

Meunier v. Minnesota Department of Revenue, 503 N.W. 2d 125 (Minn. 1993) 22

Miller v. Milwaukee, 272 U.S. 713 (1927) 19

Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895) 14, 23

Rockford Life Insurance Company v. Illinois Department of Revenue, 482 U.S. 182 (1987) 19, 28, 29

Smith v. Davis, 323 U.S. 111 (1944) 28, 29

South Carolina v. Baker, 485 U.S. 505 (1988) 14, 23-25

Stern Bros. & Co. v. Commissioner, 108 F.2d 309 (8th Cir. 1940) 16

Union Planters National Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970), *cert. denied* 400 U.S. 827 (1970) 10

United States v. California, ___ U.S. ___, 113 S.Ct. 1784, 123 L.Ed.2d 528 (1993) 29

United States v. Stewart, 311 U.S. 60 (1940) 16

Weston v. City Council of Charleston, 27 U.S. (2 Pet.) 449 (1829) 14, 23

TABLE OF AUTHORITIES

CASES: Page

Willcuts v. Bunn, 282 U.S. 216 (1931) 14-16

Yurista v. Commissioner, 460 N.W.2d 24 (Minn. 1990) 4

STATUTES AND CODES:

15 U.S.C.A. §80a-3(a)(1) 20

31 U.S.C. § 742 9

31 U.S.C. § 3124(a) 2

Cal. Rev. & Tax. Code § 17145 (West 1994) 18

I.R.C. § 851 21

I.R.C. § 852 . . . . . 21, 22

Investment Advisers Act of 1940, 15 U.S.C. §80(b)(1) et seq. 20

Investment Company Act of 1940, 15 U.S.C. §80(a)(1) et seq. 4, 7, 18, 20, 21

N.Y. Tax Law § 612(c)(1) (McKinney 1992) 18

Pub. L. 86-346, § 105(a), 73 Stat. 622 (1959) 9

Rev. Rul. 74-27, 1974-1 C.B. 24 10

Rev. Stat. § 3701 . . . . . 9, 14, 28

TABLE OF AUTHORITIES

STATUTES AND CODES: Page

Section 2137, Tax Reform Act of 1976, Pub. L. 94-455 21

Soldiers' and Sailors' Civil Relief Act, 50 U.S.C.App. § 514 25

MISCELLANEOUS:

General Explanation of the Tax Reform Act of 1976 (H.R. 10612) 94th Congress, Public Law 94-455, Joint Committee on Taxation, JCS-33-76, p. 678-679, 1976-3 C.B. vol. 2, p. 690-691 21

H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982) 9

M. Stigum, *The Money Market: Myth, Reality, and Practice* (Dow-Jones Irwin 1978) 10

O.D. 729, Cumulative Bulletin No. 3, July-December, 1920, pp. 123, 124 15

No. 93-823

In The
Supreme Court of the United States
October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE
Petitioner,
v.
JOHN LOEWENSTEIN,
Respondent.

On Writ of Certiorari to the Supreme Court of the State of Nebraska

BRIEF OF AMICI CURIAE ON THE MERITS IN SUPPORT OF THE STATE OF NEBRASKA, DEPARTMENT OF REVENUE BY THE STATE OF CALIFORNIA AND THE STATES OF ALABAMA, ARIZONA, DELAWARE, ILLINOIS, INDIANA, KENTUCKY, LOUISIANA, MARYLAND, MASSACHUSETTS, MICHIGAN, NEW HAMPSHIRE, NEW JERSEY, NEW MEXICO, NEW YORK, NORTH DAKOTA, OKLAHOMA, OREGON, UTAH, VERMONT, VIRGINIA AND WISCONSIN

INTEREST OF AMICI CURIAE

Amici are States of the United States. Under the laws of each amicus State,[1] a tax is imposed on income to the extent not prohibited by the Constitution or the laws of the United

[1] In New Hampshire, there is no general income tax but New Hampshire imposes a tax on certain income under its interest and dividends tax, to the extent not prohibited by the Constitution or laws of the United States.

States. Under 31 U.S.C. §3124(a), obligations of the United States and the interest thereon are exempt from state taxation.

This case involves important principles of federalism and could lead to unjustified limitations upon the power of the States to impose a tax which is neither prohibited by the U.S. Constitution nor in conflict with any federal law. If 31 U.S.C. §3124(a) is given the overly broad interpretation, as contemplated by the taxpayer in this case, the exemption could be extended to other nominal owners of federal obligations and other forms of income that consider the value of a federal obligation, without regard for the true economic substance of the transaction giving rise to the income taxed. Such a result would attribute an unwarranted talismanic power to federal obligations. The taxpayer's proposed interpretation of §3124(a) would result in discrimination against the States in violation of the doctrine of intergovernmental tax immunity.

Amici have a fiscal interest in the interpretation of 31 U.S.C. §3124. If this law is interpreted to prohibit state taxation of forms of income only remotely related to a federal obligation (i.e., gain on sale, repurchase agreement income, etc.), the income tax base in each State will be reduced substantially.

The decision by the Nebraska Supreme Court is at odds with rulings of other state courts around the country. The highest courts in six states have concluded that 31 U.S.C. §3124(a) does not prohibit state taxation of income from a repurchase agreement involving a federal obligation.[2] The

[2] *Comptroller of the Treasury v. First United Bank & Trust Co.*, 320 Md. 352, 578 A.2d 192 (Md. 1990); *Hammond Lead Products, Inc. v. State of Indiana Tax Commissioners*, 575 N.E.2d 998 (Ind. 1991); *Everett v. Department of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Borg* (continued...)

appellate courts in three other states reached the same conclusion.[3] The issue is currently pending before the Supreme Court of California.[4] An intermediate appellate court in Michigan is the only other state court which has reached the same conclusion as the Supreme Court of Nebraska,[5] but that decision is not authoritative.[6] Amici have an interest in seeing the decisions of their courts sustained, particularly when a substantial amount of state tax has been collected on the basis of these decisions.[7]

[2](...continued)
v. Department of Revenue, 308 Or. 34, 774 P.2d 1099 (Or. 1989); *Massman Construction Company v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *In re Thomas C. Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (Vt. 1987).

[3] *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989); *Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue*, 145 Wis. 2d 841, 429 N.W. 2d 551 (Wis. Ct. App. 1988); *Andras v. Illinois Department of Revenue*, 154 Ill. App. 3d 37, 506 N.E.2d 439, 106 Ill. Dec. 732 (Ill. App. 1987), *cert. denied*, 485 U.S. 960 (1988).

[4] *Bewley v. Franchise Tax Board*, 15 Cal.App. 4th 310 (1993), pet. for rev. granted July 22, 1993, (S033257), reprinted at 20 Cal.App. 4th 534, to permit tracking pending disposition by the California Supreme Court.

[5] *Matz v. Department of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (Mich. Ct. App. 1986).

[6] As pointed out in *Capital Preservation Fund, Inc., supra*, 429 N.W. 2d at 555, the reasoning of other state courts to the contrary is "far more persuasive on the issue than the Michigan court's unexplained *per curiam* quotation from a state agency ruling." In addition, the *Matz* decision has been distinguished even in Michigan. In *H.J. Heinz Co. v. Dept. of Treasury*, 494 N.W. 2d 850, 853 (Mich. App. 1992), the court "agree[d] with those courts which classify repo transactions as collateralized loans rather than purchases and sales."

[7] The present case is an action for declaratory judgment concerning the validity of a Nebraska regulation. It does not involve a claim for refund. As a result, the Nebraska courts did not address the extent to which their conclusions regarding 31 U.S.C. §3124(a) should be given (continued...)

Even if it were determined that section 3124(a) rendered the mutual fund's repurchase agreement income exempt in the hands of the mutual fund, that determination by itself would not require that the tax exemption be passed on to the shareholders of the mutual fund when the fund paid out dividends from the fund's income. A number of state courts around the country have also examined the question regarding the tax treatment of distributions to shareholders of mutual funds that own federal obligations. Contrary to the views expressed herein, several have concluded that 31 U.S.C. §3124(a) prohibits state taxation of distributions to shareholders of mutual funds, to the extent these distributions have their source in interest on federal obligations owned by the mutual fund.[8] No federal court has reached the same

[7](...continued)
retroactive effect.

The states, in reasonable reliance on the above consensus of the state court decisions, have collected a fiscally significant amount of taxes. If this Court were to reach a decision in this case against petitioner Nebraska, it is unclear whether, under the laws of Nebraska and the Constitution, the respondent would be entitled to a refund of taxes paid. Because of *Harper v. Virginia Department of Taxation*, 509 U.S. ___, 113 S.Ct. 2510, 125 L.Ed.2d 74 (1993), a flat affirmance of the Nebraska decision might give rise to the contention that all other states would be bound to give retroactive relief, to the extent such relief was not procedurally barred. Amici submit that if any holding were to be made against Nebraska, the case should be remanded to the Nebraska courts for consideration of how such a holding should be applied. See *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco, Dept. of Business Regulation of Florida, et al*, 496 U.S. 18, 32 n. 16 (1990).

[8] *Yurista v. Commissioner*, 460 N.W.2d 24 (Minn. 1990); *Andras v. Illinois Dept. of Revenue, supra; Matz v. Department of Revenue, supra; Capital Preservation Fund, Inc. v. Wisconsin Dep't of Revenue, supra.*, relied exclusively on 31 U.S.C. §3124(a) and the Investment Company Act of 1940 to invalidate state taxation of distributions paid to shareholders of mutual funds that receive interest on federal obligations exempt from state
(continued...)

conclusion for federal tax purposes. Most amici have an interest in an authoritative resolution by this Court of the question of whether a tax exemption enjoyed by mutual funds is automatically passed on to their shareholders when the funds' income is distributed to the shareholders in the form of dividends.

STATEMENT PURSUANT TO RULE 37

This brief is submitted pursuant to Rule 37.3 of this Court in support of petitioner, State of Nebraska, Department of Revenue. Consent to the filing of this brief has not been requested from the parties because amici filing this brief are the Attorneys General of their respective States. Rule 37.5 U.S. Sup. Ct.

SUMMARY OF ARGUMENT

Federal law, i.e., 31 U.S.C. §3124(a), prohibits state taxation of an obligation of the United States or the interest thereon. This prohibition extends to every form of taxation that requires the obligation, or the interest thereon, or both,

[8](...continued)
tax.

In other cases, i.e., *Comptroller of the Treasury v. First United Bank & Trust Co, supra; Borg v. Department of Revenue, supra; Brown v. Franchise Tax Board*, 197 Cal. App. 3d 300, 242 Cal. Rptr. 810 (1987); *In re Thomas C. Sawyer Estate, supra;* the courts invalidated state taxation of distributions paid to shareholders of mutual funds on the basis of 31 U.S.C. §3124(a) *and* the doctrine of intergovernmental tax immunity. In these cases, state law provided an exemption for distributions to shareholders of mutual funds that owned state obligations but did not provide a similar exemption for mutual funds that owned federal obligations. (The unpublished portion of *Brown, supra*, discusses the discriminatory nature of the former California statute.)

to be considered, directly or indirectly, in the computation of the tax.

Respondent is a shareholder of a mutual fund that distributed amounts attributable to the "interest" income the fund received from repurchase agreements involving federal obligations. A repurchase agreement is a financing arrangement in which the owner of a marketable security — in this case a federal obligation — temporarily relinquishes nominal ownership of the security and agrees to pay "interest" to a lender. The agreement, cast as a sale and repurchase, specifies the sale price and the repurchase price of the security, both of which are less than the market value of the obligation at the time of the agreement. The repurchase price includes a premium, frequently labeled "interest," which reflects prevailing interest rates for loans with similar collateral. The use of the term "interest" for this premium amount only reflects that this repurchase agreement is, in substance, a loan agreement wherein the mutual fund has made a loan and holds federal obligations as a form of security to ensure repayment of that loan with preset interest.

This "interest" — paid by the borrower (nominal seller) to the lender (nominal purchaser), the mutual fund in this case — provided the source of mutual fund income which was subsequently paid to shareholders of the mutual fund in the form of dividends. It is these dividends which the Nebraska Supreme Court has wedged into the immunity provided to federal obligations under 31 U.S.C. § 3124(a).

There is no reason to believe that a venerable principle of tax jurisprudence — that tax treatment should be based on economic substance rather than labels — is not applicable for purposes of exemption from state taxation pursuant to 31 U.S.C. §3124(a). The income subject to Nebraska tax in this

case is, in substance, interest paid by a private party on a loan which uses a federal obligation for collateral. Nebraska is not taxing a federal obligation or the interest thereon. The computation of the tax on income from a repurchase agreement does not require consideration of a federal obligation or the interest thereon. Consequently, the tax is not prohibited by 31 U.S.C. §3124(a).

Even if this loan arrangement were to be treated, from the standpoint of the lender, as a true purchase followed by a sale of the underlying federal obligation, the Nebraska state tax would only be taxing the gain on the resale of the federal obligation. Interest paid by the United States on a federal obligation is the only form of income that is exempt from state taxation under 31 U.S.C. §3124(a). This federal law does not prohibit state taxation of gain on the sale of a federal obligation.

Even if 31 U.S.C. § 3124(a) were to be construed to prohibit state taxation of income from a repurchase agreement involving a federal obligation, neither the Investment Company Act of 1940 nor 31 U.S.C. §3124(a) prohibits state taxation of a dividend paid to the shareholders of a mutual fund that is attributable to this income. A dividend distribution to a shareholder of a mutual fund is not interest on a federal obligation nor is it income from a repurchase agreement involving a federal obligation. Unless state law provides otherwise, a shareholder of a mutual fund is subject to state income tax on a distribution from the mutual fund, even if the income of the mutual fund includes interest on a federal obligation.

The doctrine of intergovernmental tax immunity does not prohibit nondiscriminatory state taxation of gain on the sale of a federal obligation, of income from a repurchase agreement

involving a federal obligation, or of a distribution from a mutual fund that owns a federal obligation. Moreover, prohibiting state taxation of such income while permitting federal taxation of identical income when a state obligation is involved would discriminate against the States in violation of the Constitution.

The decision of the Nebraska Supreme Court should be reversed.

ARGUMENT

I

SINCE THE NEBRASKA TAX TAXES NEITHER THE FEDERAL OBLIGATIONS THEMSELVES NOR THE INTEREST PAID BY THE GOVERNMENT, THERE IS NO EXEMPTION UNDER 31 U.S.C. §3124(a).

A. IN SUBSTANCE, THE REPURCHASE AGREEMENTS WERE LOANS; INTEREST PAID BY A PRIVATE PARTY ON A LOAN CANNOT QUALIFY FOR INCOME TAX EXEMPTION UNDER 31 U.S.C. §3124(a).

For the years in question, Section 3124(a), Title 31, United States Code, provided as follows:

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to

> be considered in computing a tax.[9]

For purposes of tax law, the primary consideration in determining the proper tax treatment of a particular transaction is economic substance of the transaction rather than its form. In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for other purposes.

> In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.[10]

A repurchase agreement is a financing arrangement where the owner of a marketable security — in this case a federal obligation — relinquishes nominal ownership of the security in an agreement purporting to sell and simultaneously repurchase the same security at a later date. The agreement specifies the sale price and the repurchase price, both of which are less than the market value of the obligation at the time of the agreement. The repurchase price includes a premium, frequently labeled "interest," which reflects prevailing interest rates for loans with similar collateral at the time of the agreement rather than the stated rate of interest on

---

[9] This reflects a 1982 reformulation of Rev. Stat. §3701, as amended, (31 U.S.C. §742). In 1959, the second sentence was added to Rev. Stat. §3701 as follows:

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax . . . (Pub. L. 86-346, §105(a), 73 Stat. 622 (1959).

In 1982, the words "directly or indirectly" were "omitted as surplus." H.R. Rep. No. 97-651, 97th Cong. 2d Sess. 94 (1982).

[10] *Helvering v. F. & R. Lazurus & Co.*, 308 U.S. 252, 255 (1939).

the underlying security.[11]

Repurchase agreements similar to those involved in the present case have repeatedly been held to be, for federal income tax purposes, secured loans rather than true sales and repurchases.[12] Although the transactions involved in the present case are, in form, a purchase and sale by the fund, the fund does not bear the risk or receive the benefit of changes in the market values of the federal obligations during the time of the fund's nominal ownership of the obligation. Purchase of the obligation by the fund, coupled with the seller-borrower's simultaneous contractual commitment to repurchase the obligations on a specific future date at the original sale price, plus "interest", regardless of the market value of such obligations on that date, insulates the fund from the possibility of any loss or gain because of a change in market value of the federal obligation.

The "interest" element in the repurchase agreement does not in any way represent interest paid by the United States in

---

[11] For a detailed discussion of a repurchase agreement see *Security and Exchange Commission v. Miller*, 495 F.Supp. 465 (1980), and M. Stigum, *The Money Market: Myth, Reality, and Practice* (Dow-Jones Irwin 1978).

[12] *First American National Bank of Nashville v. United States*, 467 F.2d 1098 (6th Cir. 1972) (purchaser of municipal bonds in repurchase agreement was not owner thereof entitled to interest exemption under Internal Revenue Code §103(a)); *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970), *cert. denied* 400 U.S. 827 (1970) (same); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970), *cert. denied* 400 U.S. 819 (1970) (same); *but see, American National Bank of Austin v. United States*, 573 F.2d 1201 (Ct. Cl. 1978) (purchaser bore sufficient risk of ownership to be treated as owner for purposes of I.R.C. §103(a)); *Citizens National Bank of Waco v. United States*, 551 F.2d 832 (Ct.Cl. 1977) (same). *See also* Rev. Rul. 74-27, 1974-1 C.B. 24 (purchaser of municipal bonds in repurchase agreement was not the owner thereof for purposes of I.R.C. §103(a)).

consideration of the use of money furnished to it by the nominal purchaser in the repurchase agreement.[13] Instead, this interest represents the consideration paid by the borrower to the fund for the use of its money (the "purchase price") during the term of the repurchase agreement. Such "interest" is not based on or otherwise attributable to interest paid by the United States but instead, is determined by market interest rates for loans of comparable duration that are secured by federal obligations. Although the fund's rights with respect to the federal obligations that are the subject of the repurchase contracts may be different for bankruptcy purposes,[14] for tax purposes, these rights are indistinguishable from the rights of a lender holding such obligations as collateral for a loan.[15]

Courts in Florida, Illinois, Indiana, Iowa, Maryland,

---

[13] The repurchase agreements involved herein provided that interest on the federal obligation remained the property of the seller-borrower. In the federal cases which examined repurchase agreements, (note 12, *supra*) state interest was paid to the nominal owner of the state obligations. In those cases, like the state cases, the borrower (substantive owner) received the economic benefit of governmental interest.

[14] In 1982, the United States District Court of the Southern District of New York concluded that repurchase agreements were collateralized loans for bankruptcy purposes. *Lombard-Wall Inc. v. Columbus Bank & Trust Co. (In re Lombard-Wall,Inc.)*, No. 82 B 11556 (Bankr.S.D.N.Y. Sept. 16, 1982). As a result, repurchase agreements could not be liquidated by selling the securities in violation of the automatic stay provisions of the Bankruptcy Code. In response to *Lombard-Wall*, the Congress enacted 11 U.S.C. §559 which provides that "[t]he exercise of a contractual right of a repo participant to cause the liquidation of a repurchase agreement . . . shall not be stayed, avoided or otherwise limited by operation of any provision of this title[.]" As a result, bankruptcy of a borrower-repurchaser will not prevent a lender from selling a federal obligation which was the subject of a repurchase agreement.

[15] See *Comptroller of the Treasury, Income Tax Division v. First United Bank & Trust Co.*, 320 Md. 352, 578 A.2d 192, 201 (1990). The terms of the repurchase agreements involved in *Comptroller v. First United Bank, supra*, are identical to those at issue in the present case.

Missouri, Oregon, Vermont and Wisconsin have examined this issue. All have used the above reasoning to agree that repurchase agreements like the agreements in this case should be treated as the loans they truly are. See notes 2 and 3, *supra*.

Respondent does not dispute the nominal nature of repurchase agreement ownership. Rather, respondent, relying on expressions by this Court in *American Bank & Trust Co. v. Dallas County*,[16] has claimed 31 U.S.C. §3124(a) provides a "broad" and "sweeping" exemption from any state taxation that diminishes "in the slightest degree" the marketability and investment attractiveness of federal obligations. The Nebraska court embraced these expressions as well.

Section 3124(a) and the effects of the 1959 amendment are the focus of *American Bank & Trust Co. v Dallas County*. "The 1959 amendment rejected and set aside th[e] Court's rather formalistic pre-1959 approach to §3701. . . . Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax." *American Bank*, supra, 463 U.S. at 862, (emphasis in original).

There is absolutely nothing in the history of 31 U.S.C. §3124(a) or the 1959 amendment to indicate the Congress intended to do anything other than abandon formalistic distinctions between acceptable and unacceptable forms of state taxation of federal obligations.

The income subject to Nebraska tax in this case is, in substance, interest paid by a private party on a loan which uses a federal obligation for collateral. It is not a tax on a

[16] 463 U.S. 855 (1983).

federal obligation or the interest thereon and, as a result, is not prohibited by 31 U.S.C. §3124(a).

B. EVEN IF THE MUTUAL FUND'S INCOME FROM A REPURCHASE AGREEMENT WERE TO BE SEEN AS INCOME FROM THE SALE OF A FEDERAL OBLIGATION RATHER THAN INTEREST ON A LOAN SECURED BY A FEDERAL OBLIGATION, INCOME FROM THE SALE OF A FEDERAL OBLIGATION IS NOT EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a).

Respondent Loewenstein argues that the tax in question here is prohibited by 31 U.S.C. §3124 because the state tax on this income requires consideration of, at least indirectly, an obligation of the United States, the interest thereon, or both. As a result, such tax purportedly is prohibited by 31 U.S.C. §3124(a). The Nebraska Supreme Court said as much. "[T]he income received by the [respondent] in this case, at the very least, is considered indirectly in computation of the tax."[17]

The respondent has argued further that 31 U.S.C. §3124(a) prohibits state taxation of income from a repurchase agreement involving a federal obligation because, when a repurchase agreement is viewed as the purchase and sale of a federal obligation, income is realized by the lender when the obligation is repurchased (sold, from the point of view of the lender). This income is the difference between the purchase

[17] *Loewenstein v. Nebraska Dept. of Revenue*, 244 Neb. 82, 90, 504 N.W.2d 800, 805 (1993), Pet. for Cert., Appendix A, at A-13.

price paid for the federal obligation and the sale price of the obligation when it is subsequently sold several days or weeks later to the original seller. There is no doubt that income exists at the time of the repurchase; however respondent's argument is based on the assumption that 31 U.S.C. §3124(a), as amended in 1959, prohibits state taxation of gain on the sale of a federal obligation. This is not correct.

In 1931, limitations on state and federal taxation imposed by the constitutional doctrine of intergovernmental tax immunity were at their historical apex. The federal government could not impose a tax on state employees,[18] state obligations, or the interest thereon.[19] Similarly, states could not impose a tax on a federal obligation or the interest thereon.[20]

Then, in *Willcuts v. Bunn*, 282 U.S. 216 (1931), a unanimous Court approved federal taxation of gain on the sale of a state obligation that was exempt from federal tax. Chief Justice Hughes, addressing taxation of gain on the sale of an exempt obligation, observed:

> The sale of bonds by their owners, after they have been issued by the state or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.[21]

---

[18] *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), overruled by *Graves v. New York ex rel*, 306 U.S. 466 (1939).

[19] *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), overruled *South Carolina v. Baker*, 485 U.S. 505 (1988).

[20] *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829); and Rev. Stat. §3701, 31 U.S.C. §742.

[21] *Willcuts, supra*, 282 U.S. at 227.

The Court relied to a substantial extent on long-established practice. "This practice clearly indicates that neither the Federal government nor the states have found a tax on the profits of the sales of their securities to be a burden on their power to borrow money. So far as we are advised, the Federal government has not at any time deemed it to be necessary to exempt from taxation the profits realized by owners on the sale of its obligations . . . ."[22] At that time, state obligations and the interest thereon were exempt from federal taxation. Federal obligations and the interest thereon were exempt from state taxation and some federal taxes. Thus, the conclusion in *Willcuts* is equally applicable to state taxation of gain on the sale of a federal obligation.

The Court also took note of Federal regulations[23] and the by-then well established Congressional practice to explicitly identify gain on the sale of a federal obligation if such income were to be exempt from taxation.[24] Certainly before 1959, gain on the sale of a federal obligation was not exempt from state taxation.[25]

The 1959 amendment is discussed in the unanimous decision in *First National Bank of Atlanta v. Bartow County*

---

[22] *Ibid*, at 232.

[23] O.D. 729, Cumulative Bulletin No. 3, July-December, 1920, pp. 123, 124. See *Willcuts, supra*, 282 U.S. at 230-231, note 5.

[24] The Court, at footnote 5 in *Willcuts, supra*, 282 U.S. at 230-231, describes the legislative progress of the Act of June 17, 1929, Ch. 26, 46 Stat. at L. 19, 20, and the enactment of the Act of June 7, 1930, Ch. 512, 46 Stat. at L. 775. In both cases, *gain from the sale or other disposition* of a federal obligation was specifically identified as an object of exemption.

[25] See *United States v. Stewart*, 311 U.S. 60 (1940); *Stern Bros. & Co. v. Commissioner*, 108 F.2d 309 (8th Cir. 1940); *Lloyd v. Commissioner*, 154 F.2d 643 (3rd Cir. 1946); *Central Hanover Bank & Trust Co. v. United States*, 83 Ct. Cl. 401, 14 F.Supp. 541 (1936); and *Agricultural Sec. Corp. v. Commissioner*, 39 B.T.A. 1103 (1939).

Board of Tax Assessors, 470 U.S. 583, 589 (1985). By enacting the 1959 amendment, "Congress intended to abolish the formalistic distinction between taxes *on* income and taxes *measured by* income. . . . [N]othing in the legislative history indicat[es] that Congress understood the addition actually to broaden the scope of the exemption, as well as to clarify the forms of taxes to which the exemption applied."[26] Certainly income tax is not a new or unique form of tax.

The factors that influenced the Court in *Willcuts* are equally persuasive today. Federal taxation of gain on the sale of a state obligation remains permissible. More importantly, the Congress knows how to extend a tax exemption to gain on a sale of an obligation and has done so in other contexts.[27]

Interest on a federal obligation has always been exempt from state income tax. There is no indication the 1959 amendment was intended to expand the objects of exemption to include gain on the sale of a federal obligation. The exemption provided by section 3124(a) continues to be limited to an obligation of the United States and the interest thereon.

Since 31 U.S.C. §3124(a) does not prohibit state taxation of gain on the sale of a federal obligation by a substantive owner, even if a repurchase agreement were really a sale of a federal obligation rather than a collateralized loan, income from a repurchase agreement, as gain on the sale of a federal

---

[26] *First National Bank of Atlanta, supra*, at 594 (emphasis in original).

[27] See note 24, supra. In addition, 31 U.S.C. §3124(b) explicitly refers to gain on the sale of a federal obligation in connection with obligations issued by the Federal Home Loan Bank Board. "The tax status of interest on obligations and dividends, earnings, or other income from evidences of ownership issued by the Government or an agency and *the tax treatment of gain and loss from the disposition of those obligations* and evidences of ownership is decided under the Internal Revenue Code . . . ." 31 U.S.C. §3124(b) (emphasis added).

obligation, would not be exempt from state taxation.

C. NO MATTER WHAT TAX EXEMPT INCOME A MUTUAL FUND MIGHT DERIVE IN CONNECTION WITH FEDERAL OBLIGATIONS, THE FACT THAT SUCH INCOME PROVIDES THE SOURCE FOR A DISTRIBUTION BY THE FUND TO ITS SHAREHOLDER DOES NOT RENDER THE DISTRIBUTION EXEMPT FROM STATE TAXATION UNDER 31 U.S.C. §3124(a).

Petitioner conceded below that 31 U.S.C. §3124(a) prohibits state taxation of distributions received by the respondent as shareholder of a mutual fund to the extent such distributions are traceable to interest on a federal obligation. Several state courts have concluded likewise.[28] The Nebraska Supreme Court did not consider the issue.

However, for the question presented to be fully answered in favor of the taxpayer, there would need to be at least two determinations: (1) that the income in the hands of the mutual fund was exempt under section 3124(a); and (2) that this tax immunity enjoyed by the mutual fund somehow was passed through to its shareholders when the mutual fund later made dividend distributions.

It is amici's position that, unless a state's law provides otherwise, section 3124(a)'s tax exemption cannot be passed through from the mutual fund (which actually received the

---

[28] Note 8, *supra*.

income in question) to its shareholders.[29] This result would obtain whether the facts in a particular case involved (as in this case) the fund's income from repurchase agreements or (as in cases such as *Brown v. Franchise Tax Board* and other cases cited above at note 8) the interest income received by the fund from the federal government on federal obligations owned by the fund.

Courts that have determined mutual fund shareholders share the benefits of section 3124(a) have relied on two federal laws — 31 U.S.C. §3124(a) and the Investment Company Act of 1940[30]. This reliance is misplaced.

As explained by the Court in *First National Bank of Atlanta v. Bartow County Board of Tax Assessors*, *supra*, and *Rockford Life Insurance Company v. Illinois Department of*

[29] Section 3124(a) of Title 31, United States Code, does not mandate an exemption from state taxation for a dividend paid to the shareholder of a mutual fund even if the fund owns a federal obligation and receives interest thereon. However, any state may (and several states do) provide an exemption from state taxation for dividends from a mutual fund. For example, under section 17145 of the Revenue and Taxation Code of California, a mutual fund with at least 50 percent of its total assets invested in federal obligations is permitted to pay exempt-interest dividends to its shareholders. Exempt-interest dividends received by shareholders are exempt from California's personal income tax. The amount of exempt-interest dividends is based on total interest received on exempt obligations, reduced by expenses attributable thereto. See also New York Tax Law § 612(c)(1).

[30] Some state courts have also invalidated state taxation of distributions received by shareholders of mutual funds that own federal obligations because the state tax discriminated against funds which invested in federal obligations. In these cases, distributions from mutual funds related to the receipt of interest on state obligations were exempt from state taxation, while comparable distributions related to the receipt of interest on federal obligations were not. This was viewed, correctly, as a violation of the doctrine of intergovernmental tax immunity discussed *infra*.

Revenue,[31] the 1959 amendment to 31 U.S.C. §3124(a) was intended to eliminate formalism in distinguishing between acceptable and unacceptable *forms* of taxation that were under consideration by the states (Idaho in particular) to circumvent the prohibitions of §3124(a).

In *American Bank and Trust*, *supra*, 463 U.S. at 855, this Court concluded that a bank shares tax (a form of property tax), nominally imposed on bank shareholders (but paid by the bank), and computed on the basis of the net assets of the bank, was prohibited by 31 U.S.C. §3124(a), as amended in 1959, because the value of federal obligations was included in the measure of the tax. This decision did not hold that shareholders of a corporation are entitled to an exemption from state income tax for otherwise taxable distributions from the corporation because the corporation owns federal obligations and receives tax exempt interest thereon. Extending 31 U.S.C. §3124(a) to prohibit a state income tax on shareholders of mutual funds that own federal obligations requires ignoring a traditionally significant tax paying entity — a corporation.[32] In this context it would be inappropriate to discard the significant distinctions that exist between a shareholder and a corporation in the name of eliminating formalism concerning state taxation of federal obligations.

The courts which have granted exemption to mutual fund shareholders have concluded that exemption under 31 U.S.C. §3124(a) is passed through to shareholders of a mutual fund because a mutual fund is different from other corporations.

[31] 482 U.S. 182 (1987).

[32] This Court has concluded that "a corporation is a nonconductor that cuts off connection between dividends to its stockholders and the corporate funds from which the dividends are paid." *Miller v. Milwaukee*, 272 U.S. 713, 714 (1927).

These arguments and decisions invariably rely on this Court's description of a mutual fund in *Burks v. Lasker*[33] as "a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." This reliance is not justified.

Burks was not remotely related to taxation or factors relevant to tax determinations. It addressed the ability of disinterested directors to terminate a shareholder's derivative suit under the Investment Company and Investment Advisers Acts (15 U.S.C. §§80a-1 et seq. and 80b-1). The nature of a shareholder's ownership interest in the securities owned by the fund was not examined in or determinative of the Court's holding.

The Investment Company Act of 1940 established federal authority for a registered investment company, commonly referred to as a mutual fund. A mutual fund engages primarily in the business of investing, reinvesting, or trading in securities. It is authorized to issue securities[34] that reflect ownership of the company and is classified as a corporation for tax purposes.[35]

The Investment Company Act does not provide special tax treatment for shareholders of mutual funds that invest in tax exempt obligations. In 1976, more than thirty years after enactment of the Investment Company Act, the Internal Revenue Code was amended to allow certain mutual funds to

---

[33] 441 U.S. 471, 480 (1979).

[34] See 15 U.S.C.A. §80a-3(a)(1) for definition. Although the investment companies involved herein were organized as Massachusetts business trusts, this distinction is not relevant to the issues involved herein because such a trust, like an investment company, is treated as an association for income tax purposes and taxed as a corporation.

[35] See Internal Revenue Code sections 851(a)(1) and 852(b).

pay tax-exempt distributions.[36] Before that time, distributions from all mutual funds to shareholders, even though attributable to interest on a state obligation owned by the fund, were subject to federal income tax.

Thus when the Congress wanted to provide preferential treatment for distributions of mutual funds that invested in state obligations, it did so by providing a special statutory regime — tax exempt distributions.[37] Mutual funds that meet certain requirements are permitted to pay tax-exempt distributions. Shareholders are not subject to income tax on tax-exempt distributions. These rules have the effect of pass-through treatment when the statutory conditions are met. They do not, however, establish any general rule that shareholders of a mutual fund should be treated as if they were owners of the assets of the fund for federal tax purposes. In fact, the Congress has concluded that shareholders of mutual funds are not owners of assets owned by the fund for tax purposes.[38]

The Nebraska Supreme Court's holding of exemption from state taxation for mutual fund distributions necessarily is based on a broad and sweeping interpretation of 31 U.S.C. §3124(a). Under this interpretation, every dollar of a mutual fund distribution traceable to federal interest would be exempt from state taxation. This overly broad interpretation is

---

[36] See Section 2137, Tax Reform Act of 1976, Pub. L. 94-455, which added sections 265(a)(3) and 852(b)(5) to the Internal Revenue Code, (Title 26, United States Code).

[37] As defined in Internal Revenue Code §852(b)(5), as added by §2137(c), Pub. L. No. 94-455, 90 Stat. 1520.

[38] See *General Explanation of the Tax Reform Act of 1976* (H.R. 10612) 94th Congress, Public Law 94-455, Joint Committee on Taxation, JCS-33-76, p. 678-679, 1976-3 C.B. vol. 2, p. 690-691.

inconsistent with the very exact approach which Congress has taken when actually dealing with mutual fund distributions. As to taxation of income from state obligations, section 852 of the Internal Revenue Code limits exempt interest distributions from mutual funds to net interest (state interest reduced by expenses attributable thereto) and then only if the mutual fund retains a minimum of 50 percent of its total assets invested in state obligations.

Amici do not question the value of mutual funds to the nation's economy and individual investors. However, to exempt from state taxation the distributions from mutual funds which own federal obligations solely on the basis of 31 U.S.C. §3124(a), without a clear statutory basis for not extending the same treatment to other entities such as normal corporations, pension funds,[39] etc., creates a dangerous precedent. Furthermore, unjustified erosion of the income tax base for the States will become more likely and be more difficult and burdensome to resist.

---

[39] The argument that a pension payment is exempt from state taxation on the basis of 31 U.S.C. §3124(a) because the pension fund owned federal obligations was examined and specifically rejected by the Minnesota Supreme Court in *Meunier v. Minnesota Department of Revenue*, 503 N.W. 2d 125 (Minn. 1993). The court considered the fact that pensions paid by plans with funds invested in state obligations were not exempt from federal income tax even though interest received on these obligations is exempt from federal income tax under I.R.C. §103(a). Given these circumstances, the court concluded that an interpretation of 31 U.S.C §3124(a) that would prohibit state taxation of pensions from plans which invest in federal obligations and receive interest thereon "would . . . constitute a violation of the doctrine of intergovernmental tax immunity . . . .", 503 N.W. at 131.

II

PROHIBITING THE STATE TAXATION AT ISSUE WOULD VIOLATE THE DOCTRINE OF INTERGOVERNMENTAL TAX IMMUNITY.

A. DISCRIMINATORY TAXATION IS PROHIBITED.

In general, the doctrine of intergovernmental tax immunity emanates from the duality of sovereignty in our federal system. It was first articulated in *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), where a state tax imposed on a national bank was held to be unconstitutional. Ten years later, the doctrine was interpreted to prevent state taxation of interest on a federal bond. A state tax on interest from a federal bond was "thought by th[e] court to be a tax on the contract, a tax on [government's] power to borrow money . . . and consequently to be repugnant to the Constitution." *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449, 469 (1829). Similarly, interest on state obligations was exempt from federal taxation. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), overruled *South Carolina v. Baker*, 485 U.S. 505 (1988).

At one point, the doctrine was expressed as follows: "neither the Federal nor the State Governments could tax income an individual directly derived from any contract with another government." See the discussion of the evolution of the doctrine in *South Carolina v. Baker*, *supra*, 485 U.S. at 517. Taxing the income from a contract was considered to be a tax on the contract and the parties to the contract. Since one of the parties to the contract was the other government, the

tax was unconstitutional.[40] As a reflection of this rule, "it was also unconstitutional [for the federal government] to tax a state employee on income earned from his employment contract, *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), to tax a lessee on income derived from lands leased from a State, *Burnet v. Coronado Oil*, 285 U.S. 393 (1932), or to impose a sales tax on proceeds a vendor derived from selling a product to a state agency, *Indian Motorcycle Co. v. United States*, 283 U.S. 570 (1931). Income derived from the same kinds of contracts with the Federal Government were likewise immune from taxation by the States."[41]

The scope of immunity began to diminish in the 1930s. Under the modern doctrine of intergovernmental tax immunity, the States can never tax the United States directly but can tax any private parties with whom it does business, so long as the tax does not discriminate against the United States or those with whom it deals. Likewise, the Federal Government can tax any private parties with whom the State does business, so long as the tax does not discriminate against the States.[42] In the modern era of intergovernmental tax jurisprudence, a federal tax imposed on those who deal with the States has survived constitutional scrutiny because the tax did not discriminate against the States.[43]

It has been a principle of tax immunity jurisprudence that

---

[40] As pointed out in *South Carolina v. Baker*, at footnote 11, 485 U.S. at 517, the sources and scope of tax immunity of the federal government and state governments are different.

[41] *South Carolina v. Baker*, supra, 485 U.S. at 517.

[42] *South Carolina v. Baker, supra*, 485 U.S. at 523.

[43] See *South Carolina v. Baker, supra*, 485 U.S. at 527; *Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 386-387 (1933); *Graves v. New York ex rel*, 306 U.S. 466, 485 (1939).

the rules for determining whether a particular tax offends the immunity of the other sovereign are the same for the federal government and the States. This is not to say that scope of immunity is exactly coextensive. Certainly, the federal government can enact a statute that extends the immunity provided by the Constitution,[44] so long as it does so in a manner that does not discriminate against the States. The notion of parallel treatment has been most recently articulated in *South Carolina v. Baker*.

> [F]ederal and state tax immunity cases have always shared the identical methodology for determining whether a tax is "on" a government, and . . . this identity has persisted even though the methodology for both federal and state immunities has changed as intergovernmental tax immunity doctrine shifted into the modern era.[45]

In *Davis v. Michigan Dept. of Treasury*,[46] the Court examined exemptions from state taxation for retired state employees. Discrimination in favor of those who were employed by a state, coupled with the absence of similar treatment for those who were employed by the United States, was unconstitutional because it discriminated against the United States.[47] *Davis* also stands for the principle that the

---

[44] An example would be the immunity from state taxation provided by the Soldiers' and Sailors' Civil Relief Act, 50 U.S.C.App. §514. This federal law, among other limitations on state taxation, prevents a state from imposing a personal property tax on personal property located within a State if the property is owned by a member of the armed forces who is domiciled in another State and located within the taxing State solely due to military orders.

[45] Footnote 11, *South Carolina v. Baker, supra*, 485 U.S. at 518.

[46] 489 U.S. 803 (1989).

[47] *Davis, supra*, 489 U.S. 814-817.

doctrine of intergovernmental tax immunity prohibits discriminatory tax exemptions. In *Davis*, the Court concluded that the Constitution required federal retirees be treated equally with state retirees. Two remedies were available to Michigan — extend preferential treatment to federal retirees or repeal preferential treatment for state retirees.

Similar concerns motivated several state courts which have examined discriminatory state taxation of distributions from mutual funds.[48] In those cases, the courts applied the doctrine of intergovernmental tax immunity to strike down the respective discriminatory state statutes. If, however, a state tax does not discriminate against the United States or those who dealt with it (such as mutual funds that dealt with federal obligations), it would not violate the doctrine of intergovernmental tax immunity.

B. FEDERAL TAX TREATMENT OF STATE OBLIGATIONS.

Since the rules of intergovernmental immunity are essentially the same for both the States and the Federal Government, tax exemption in favor of those who deal with the United States is unconstitutional unless similar treatment is extended to those who deal with the States on the same basis.[49]

---

[48] See second paragraph, note 8, *supra*.

[49] Although the rationale for the immunity of the federal government and the States may be different, the Court has never articulated a different measure of discrimination to gauge the constitutionality of a State statute imposing a state tax on those who deal with the United States and a federal statute granting exemption from state taxation for those who deal with the United States.

For example, Congress cannot exempt income from federal contracts from state taxation unless it also provides a comparable exemption from federal taxation for income from similar state contracts. Since the federal government cannot tax those who deal with the states in a way that discriminates against the states, and since the federal tax exemption for income from state obligations is subject to conditions which would not be present in respondent's application of 31 U.S.C. §3124(a) as to federal obligations, respondent's interpretation of that section would violate intergovernmental tax immunity.[50]

Federal law does not prohibit federal taxation of income from a repurchase agreement involving a state obligation, distributions from a mutual fund traceable to interest on a state obligation or gain on the sale of a state obligation. If federal law is interpreted to prohibit state taxation of this same income when federal obligations are involved, federal obligations will be more attractive than state obligations as investments, discriminating in favor of federal obligations and against the States.

C. SPECIAL CONSIDERATIONS APPLICABLE TO INTERGOVERNMENTAL TAXATION.

Citing *Smith v. Davis*,[51] respondent has argued that "the

---

[50] The Minnesota Supreme Court concluded that an interpretation of 31 U.S.C. §3124(a) which provided preferential treatment for pension plans that invest in federal obligations when pension plans that invest in state obligations were not provided comparable treatment for federal tax purposes was a violation of the doctrine of intergovernmental tax immunity. See the discussion at note 39, supra.

[51] 323 U.S. 111 (1944).

long established Congressional intent [of §3124 is] to prevent taxes which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit."[52] Respondent's citation to *Smith v. Davis* ignores the context within which it was expressed. The question in *Smith v. Davis* was whether §3701 (the predecessor of §3124) would prohibit a state tax that included the contract liability of the federal government to a government contractor in the measure of the tax. The Court concluded that §3701 did not prohibit such state taxation because the obligation was not included within the objects that were exempted by §3701 — it was not an obligation of the United States for purposes of §3701.

In *Rockford Life Ins. Co. v. Ill. Dept. of Revenue*, *supra*, the Court had no difficulty rejecting a claim that the state tax should be invalidated because it would have an economic effect on the United States. *Alabama v. King & Boozer*,[53] *Graves v. New York ex rel*,[54] and *James v. Dravo Contracting Co.*,[55] support the notion that economic effect is not determinative. All three are cited with approval for this proposition by the Court in *Rockford*.[56] "Immunity from taxation 'may not be conferred simply because the tax has an effect on the United States.' [citing] *United States v. New Mexico*, 455 U.S. 720, 734 (1982)."[57]

More importantly, the holding and rationale in *Smith v.*

---

[52] *Smith*, *supra*, 323 U.S. at 117.
[53] 314 U.S. 1, 8 (1941).
[54] 306 U.S. 466, 487 (1939).
[55] 302 U.S. 134, 160 (1937).
[56] *Rockford*, *supra*, footnote 11, 482 U.S. at 191.
[57] *Ibid.*; see also *United States v. California*, ___ U.S. ___, 113 S.Ct. 1784, 123 L.Ed.2d 528, 537-38 (1993).

Davis support the petitioner, Nebraska, in this case. The validity of a state tax was affirmed because the liability of the federal government to pay its contractor was not an obligation of the United States, for purposes of §3124. In interpreting the predecessor of §3124, the Court concluded that "[t]ax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under [§3124] is necessary . . . ."[58]

The validity of this approach to statutory interpretation regarding a federal exemption from state taxation in general and §3124 in particular was reaffirmed by the Court in *Rockford Life Ins. Co.*, *supra*. In addressing the question of whether §3124 prohibits state taxation of obligations guaranteed by the Government National Mortgage Association, commonly known as "Ginnie Maes," this Court, quoting from *Smith v. Davis*, cautioned once again:[59]

> A court must proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly established. We do well to remember the concluding words in *Smith*, which although spoken in reference to the statute, are relevant to our role in applying the constitutional doctrine as well:
>
> > All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government. That

---

[58] *Smith v. Davis*, supra, 323 U.S. at 117.
[59] *Rockford Life Ins. Co.*, *supra*, 482 U.S. at 191.

> intent, which is largely codified in [§3124], should not be expanded or modified in any degree by the judiciary. 323 U.S. at 119.

Since §3124 must be construed narrowly and it does not explicitly include distributions from mutual funds attributable to income from repurchase agreements involving federal obligations, §3124 does not prohibit state taxation of this income.

CONCLUSION

Federal law, i.e., 31 U.S.C. §3124(a), and the constitutional doctrine of intergovernmental tax immunity do not prohibit State taxation of a shareholder of a mutual fund on a distribution from the fund traceable to income from a repurchase agreement involving an obligation of the United States.

The decision of the Supreme Court of Nebraska should be reversed.

Dated: April 29, 1994

Respectfully submitted,

DANIEL E. LUNGREN
Attorney General of the
State of California

TIMOTHY G. LADDISH
Assistant Attorney General

Of Counsel:
PATRICK J. KUSIAK
Tax Counsel
Legal Division
Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95812-1468

JOYCE E. HEE
Deputy Attorney General
(Counsel of Record)
2101 Webster Street
Oakland, CA 94612
(510) 286-4044
Counsel for Amici Curiae